Office of Chief Counsel
Internal Revenue Service
memorandum
CC:LM:FS:LI:TL-N-4214-01
TKerrigan

date:

to: Territory Manager (Retail, Food & Pharmaceuticals)
Attention: Group 1518-LMSB

from: Associate Area Counsel
CC:LM:FS:BRK

subject: [redacted]
Taxable year: [redacted]
U.I.L. No. 0451.00-00, 0461.07-01

This memorandum is in response to a request for advice, dated July 3, 2001, from Betty Munch of your staff concerning the proper tax treatment of commissions received by the above-referenced taxpayer.

ISSUES

1. Whether, under the facts presented, commissions received by the taxpayer should be included in income for the taxable year at issue?

2. If it is determined that the commissions are taxable income, whether the taxpayer is entitled to claim an offsetting I.R.C. § 461(f) contested liability deduction?

FACTS

The relevant facts, as we understand them, are as follows: [redacted] is an importer and distributor of active pharmaceutical ingredients. The company also acts as an agent for foreign manufacturers of these products. The taxpayer files its corporate tax return on the basis of a fiscal year ending [redacted] and has adopted the accrual method of accounting.

On [redacted], the taxpayer entered into [redacted] exclusive licensing agreements with [redacted], a generic drug manufacturer. The taxpayer acted as agent for [redacted], an Italian based chemical manufacturer. Under the [redacted] agreements, [redacted] agreed to sell [redacted] the key ingredients used in the manufacturing of two [redacted] drugs, [redacted] and [redacted]. The taxpayer received commission payments as compensation for its services in negotiating the agreements.

On [redacted], the [redacted] filed a complaint against Mylan, [redacted], [redacted][1] and [redacted] alleging that the defendants engaged in anti-competitive practices that illegally restrained competition and raised the price of the generic medications. In the complaint, the [redacted] sought injunctive relief enjoining the unlawful conduct and disgorgement of the profits that resulted from the exclusive manufacturing licensing agreements. On [redacted], the parties agreed to a proposed settlement of these claims. Under the tentative agreement, [redacted] deposited $[redacted] in a special escrow settlement account. These funds will be used to reimburse consumers and state agencies for overcharges incurred from purchasing both drugs. The Court will hold a final approval hearing on [redacted].

During the tax year at issue, the taxpayer received commission payments in the amount of $[redacted] from the licensing agreements. These payments were received subsequent to the filing of the [redacted] complaint. The taxpayer, however, failed to include these payments in its gross income.[2] [redacted] maintains that these funds are "substantially at risk" and may have to be relinquished to the [redacted] in the future. The taxpayer represents that it has set aside these funds into a separate commercial paper account pending final resolution of the [redacted] matter. Based on the above, the taxpayer contends that commissions received are properly treated as "deferred liabilities" rather than "ordinary income". These payments are reflected on the corporate balance sheet as a current liability. The revenue agent counters that the commissions received are taxable income and that the taxpayer cannot defer reporting these commission payments.

LEGAL ANALYSIS

1. Commission Income

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[1] [redacted] is a wholly owned subsidiary of [redacted]

[2] The taxpayer also received two commission payments from [redacted] in fiscal year [redacted] totaling $[redacted]. The taxpayer included these payments as income on its [redacted] tax return.

I.R.C. § 451(a) provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for in a different period. Treas. Reg. § 1.451-1(a) provides, in relevant part, that under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. In general, when a taxpayer's entitlement to income from a contract or other type of obligation is disputed by the obligor, all events have not occurred to the right to the income. Therefore, income from disputed obligations is not properly accruable until the dispute is resolved. See Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 299 (1932); Dally v. Commissioner, 227 F.2d 724, 727 (9th Cir. 1955) aff'g 20 T.C. 894 (1953); Orange & Rockland Utilities, Inc. v. Commissioner, 86 T.C. 199, 214 (1986).

All events that fix the right to receive income occur when the required performance takes place and either payment is due or made. Schulde v. Commissioner, 372 U.S. 128 (1963). In this case, [redacted], the obligor, has already made commission payments consistent with terms of the exclusive licensing agreements. Accordingly, there is no dispute with respect to the taxpayer's right to receive such income from [redacted]. Here, the facts and circumstances require accrual of the commission income in the taxable year at issue.

2. I.R.C. § 461(f) Contested Liability Deduction

The remaining issue is whether the taxpayer is entitled to a business expense deduction commensurate with the commission income accrued. I.R.C. § 162(a) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. I.R.C. § 461(a) provides that the amount of any allowable deduction shall be taken in the proper taxable year under the method of accounting used in computing taxable income. The taxpayer maintains that it may be required to surrender all or part of its commission payments to the [redacted] in settlement of that case and other pending class action lawsuits.

An accrual method taxpayer generally may not deduct an expense until: (1) all events have occurred which determine the fact of the liability; (2) the amount thereof can be determined with reasonable accuracy; and (3) economic performance has occurred with respect to the expense. Dixie Pine Products Co. v. Commissioner, 320 U.S. 516 (1944); I.R.C. § 461(h); Treas. Reg. § 1.461-1(a)(2). I.R.C. § 461(f) provides a narrow statutory exception to this general rule for contested liabilities.[3] Under I.R.C. § 461(f) and the regulations promulgated thereunder, an accrual basis taxpayer contesting a liability may be entitled to a current deduction for amounts paid on account of the asserted liability. A taxpayer must satisfy the following four requirements: (1) it was contesting an asserted liability during the year; (2) it transferred money or other property to satisfy that liability; (3) the contest with respect to the asserted liability continued after the transfer, and (4) a deduction would be allowed for the taxable year of the transfer (or an earlier tax year), but for the fact of the contest. Davies v. Commissioner, 101 T.C. 282, 286 (1993).

A taxpayer must provide for the satisfaction of the asserted liability by transferring money or property beyond the taxpayer's control in order to qualify for a deduction under section 461(f). Treas. Reg. § 1.461-2(c)(2) contains two examples illustrating the "transfer" requirement. Example 1, which is factually comparable to this case, provides as follows:

> M Corporation contests a $5,000 liability asserted against it by L Company for services rendered. To provide for the contingency that it might have to pay the liability, M establishes a separate bank account in its own name. M then transfers $5,000 from its general account to such separate account. Such transfer does not qualify as a transfer to provide for the satisfaction of an asserted liability because M has not transferred the money beyond its control.

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[3] I.R.C. § 461(f) was enacted by Congress in 1964 in response to the Supreme Court's decision in United States v. Consolidated Edison Co., 366 U.S. 380 (1961), which held that a contested tax, though paid, was not deductible until the contest was terminated. According to the Court, all events fixing the fact and amount of the liability do not occur until the contest is resolved. The legislative history for section 461(f) states that "allowing the deduction of items in the year paid, even though they are still being contested in the courts or otherwise, more realistically matches these deductions up with the income to which they relate than would the postponement of the deduction." S. Rept. 830, 88th Cong., 2d Sess. (1964), 1964-1 C.B. (Part 2) 604.

In this case, the taxpayer maintains that it may be required to surrender all or part of its commission payments in settlement of the [redacted] case and other pending class action lawsuits. Although the taxpayer may have segregated the funds into a separate commercial paper account, it has not transferred any funds beyond its control. Here, no transfer within the meaning of I.R.C. § 461(f) has occurred. Therefore, the statutory exception for contested liabilities is not applicable.

Moreover, we note that [redacted] rather than the taxpayer appears to be the sole source of funds for the proposed settlement. The settlement funds will be distributed to individual consumers and state agencies who were overcharged. The court has given preliminary approval to the settlement but the agreement will not be finalized until [redacted]. Therefore, the taxpayer does not even satisfy the "all events" test outlined above since it is not possible to determine the amount of the taxpayer's ultimate liability, if any, in the pending [redacted] lawsuit.

CONCLUSION

Based on the foregoing, the taxpayer is required to report commissions received from [redacted] in its gross income. The taxpayer may not claim a current deduction for the asserted [redacted] liability because the taxpayer has neither established the amount of its liability nor transferred funds beyond its control to satisfy the liability.

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon. You should be aware that, under routine procedures, which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions or require further assistance, please contact Thomas Kerrigan at (516) 688-1742.

ROLAND BARRAL
Area Counsel

By: ______________________________
JODY TANCER
Associate Area Counsel